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CAPITALIZATION RATES ARE INCREASING

REAL estate appraisers should bear in mind constantly that capitalization rates change. Those familiar with the period of the twenties and the early part of the thirties can remember when the general practice was to capitalize the building at 8% and the land at 7%. In recent years, due to the abundance of credit at low interest rates, the capitalization rate, both on land and buildings, has gone down. Interest rates probably hit their lowest point about two years ago and the increases in the values of investment properties which came about because of lower capitalization rates have spent their force. The long-term outlook is certainly for increases in the capitalization rate, and if this be true, it will have the effect of lowering the values of investment properties if all other factors responsible for value changes remain the same.

One of the best definitions of a capitalization rate is given in the June 14, 1948, edition of the Appraisal Terminology Manual, published by the American Institute of Real Estate Appraisers. It defines that rate as "the hoped-for rate of return from an investment; a rate at which income is processed (capitalized) to indicate the probable capital value." In other words, a capitalization rate is a rate of return required to attract sufficient capital. It is a so-called interest rate based primarily on four factors or individual rates, namely: 1. pure interest rate; 2. rate for non-liquidity; 3. rate for management; and 4. risk rate. A change in any one or combination of these individual rates will affect the capitalization rate. Time generally changes the pure interest rate, while the security offered by various types of property as collateral changes the risk rate.

In the past few years we have heard many appraisers make the statement that they have disregarded the income approach in the evaluation of apartments and other income-producing properties because the value by this approach falls short of the value by the comparative or sales approach. In our opinion, these appraisers failed to observe the constant changes in capitalization rates. Many of them use the same rates on class A properties as they would on highly speculative parcels. Furthermore, many of them have been using the same rate throughout boom and depression times. This is an error that many of us have made in the past and that we hope to avoid in the future. No matter how well the income and expenses are estimated, a slight error in the capitalization rate will be magnified and result in a totally erroneous finding.

In our opinion, the current change that is taking place in the capitalization

rate is due primarily to the factor of pure interest. Pure interest can be described as the return to capital which would be required to attract sufficient capital into the money market were there no risk whatever involved in the investment nor in the collateral, if the capital so invested could be withdrawn at any time and if the investment required no supervision. This rate is a strictly theoretical rate, and probably the closest approach to it is short-term negotiable government bonds. The current rate of interest on these bonds is 1.6% per annum, a 54% increase over the average of 1948. The present mortgage crisis seriously, rapidly and with little warning affected this item of the capitalization rate when the United States Treasury allowed the interest rate on long-term government bonds to rise from 2.5% to 2.75%. At the same time the Federal Reserve System permitted the market to seek its own level for the long-term U. S. debt, which prior to this time had been kept convertible into cash at par, or better. Throughout February, savings banks and insurance companies had been sailing along on a mortgage policy that had little concern for future increases in their available investment funds. Prior to this time these funds were primarily secured by consistently disposing of some of their longest term peggedgovernment bond holdings which paid lesser returns than the mortgage money.

The change in the Federal Reserve practice halted this conversion policy, for when bond prices fell, the switch could be made only by taking a capital loss rather than the profit which had been customary. Furthermore, the attractiveness of the practice was further reduced when the bond yield was increased 0.25% without allowance of a corresponding increase in the return on VA and FHA mortgages.

All other types of investments increased their yields correspondingly except the part of the home building industry which was dependent on FHA and VA loans for its financing. Stocktaking by the lending institutions disclosed commitments for almost a year ahead for more VA and FHA mortgages than they could well absorb without selling any of their demonetized bonds at a loss. Eighty-seven and a half per cent of the increase in mortgage money during the last half of 1950 was the result of the sale of government bonds. Consequently, with this method of augmenting mortgage funds eliminated and with lenders already overcommitted and with other yields higher, the demand for VA-FHA loans has practically disappeared.

All of this action has had a tendency to increase the pure interest rate.

The non-liquidity factor varies with the terms of the investment and with its negotiability. The longer the maturity, or the time necessary to return the original investment, the greater will be the non-liquidity factor. Over a ten-year period the $2\frac{1}{2}\%$ rate on series E bonds would indicate the pure interest rate and a non-liquidity rate for the ten years. The non-liquidity rate also varies with the type of property. A small well-built residence or a well-located store building would have a small rate, while a large, expensive special-use property would have a considerably higher rate.

SUPPLEMENTAL COST DATA FOR THE WENZLICK STANDARD BUILDINGS

Bringing Cost Tables Up to Date as of July 1951

			Total M	Total L	Overhead	TOTAL	Cu. ft. cost	Sq. ft. cost
Six-room	Ag	1950	$ 7,190	$ 4,496	$ 2,972	$ 14,658	60.4¢	$ 8.88
frame house	S	1950	7,347	4,496	2,996	14,839	61.1	8.99
(See table	O	1950	7,572	4,496	3,027	15,095	62.2	9.15
pgs. 346-347)	N	1950	7,519	4,672	3,072	15,263	62.8	9.25
	D	1950	7,519	4,672	3,072	15,263	62.8	9.25
	Ja	1951	7,505	4,676	3,066	15,247	62.8	9.24
	F	1951	7,828	4,676	3,113	15,617	64.3	9.46
	Mr	1951	7,956	4,676	3,138	15,770	64.9	9.56
	Ap	1951	7,950	4,680	3,137	15,767	64.9	9.56
	My	1951	7,901	4,680	3,147	15,728	64.8	9.53
	Je	1951	7,861	4,680	3,141	15,682	64.6	9.50
	Jl	1951	7,815	4,697	3,143	15,655	64.5	9.49
Five-room	Ag	1950	6,280	4,615	2,659	13,554	54.4	11.63
brick house	S	1950	6,440	4,615	2,682	13,737	55.1	11.79
(See table	O	1950	6,617	4,615	2,707	13,939	56.0	11.96
pgs. 350-351)	N	1950	6,557	4,787	2,739	14,083	56.5	12.09
	D	1950	6,593	4,787	2,743	14,123	56.7	12.12
	Ja	1951	6,554	4,780	2,729	14,063	56.4	12.07
	F	1951	6,642	4,780	2,743	14,165	56.9	12.16
	Mr	1951	6,744	4,777	2,771	14,292	57.4	12.27
	Ap	1951	6,723	4,756	2,757	14,236	57.1	12.22
	My	1951	6,657	4,756	2,741	14,154	56.8	12.15
	Je	1951	6,653	4,756	2,746	14,155	56.8	12.15
	Jl	1951	6,653	4,765	2,751	14,169	56.9	12.16
Six-room	O	1950	7,205	5,450	2,840	15,495	67.1	10.19
brick house*	Ja	1951	7,140	5,820	3,110	16,070	69.6	10.57
(See table	Ap	1951	7,327	5,880	3,170	16,377	70.9	10.77
pgs. 410-411	Jl	1951	7,327	5,890	3,179	16,396	71.0	10.79
California	O	1950	4,011	2,471	1,660	8,142	67.2	8.21
bungalow	N	1950	3,959	2,582	1,680	8,221	67.8	8.29
(See table	D	1950	3,965	2,582	1,680	8,227	67.9	8.29
pgs. 416-417)	Ja	1951	3,990	2,573	1,687	8,250	68.1	8.32
	F	1951	4,059	2,573	1,698	8,330	68.7	8.40
	Mr	1951	4,137	2,569	1,714	8,420	69.5	8.49
	Ap	1951	4,146	2,570	1,724	8,440	69.6	8.51
	My	1951	4,110	2,570	1,720	8,400	69.3	8.47
	Je	1951	4,095	2,570	1,719	8,384	69.2	8.45
	Jl	1951	4,092	2,585	1,723	8,400	69.3	8.47
18-fam. apt.*	Ja	1951	78,063	51,977	22,969	153,009	90.9	11.54
(See table	Ap	1951	80,097	52,594	23,373	156,064	92.7	11.77
pgs. 532-533)	Jl	1951	80,097	52,675	23,389	156,161	92.9	11.78
30-fam. apt.*	Ja	1951	172,019	104,769	47,763	324,551	106.9	15.19
(See table	Ap	1951	176,342	106,195	48,800	331,337	109.2	15.50
pgs. 536-537)	Jl	1951	173,359	106,490	48,457	328,306	108.2	15.36
Commercial	Ja	1951	18,953	16,227	13,509	48,689	42.0	6.03
building*	Ap	1951	19,217	16,252	13,588	49,057	42.3	6.08
(See table	Jl	1951	19,187	16,223	13,530	48,940	42.2	6.06
pgs. 544-545)								

*Computed on a quarterly basis.

This replaces the final page of your Construction Cost Manual.

The rate for management or supervision in a capitalization rate includes the cost of securing and investigating the original venture, bookkeeping, collections, the cost of reinvesting the annual return of capital, and the cost of regular examinations of the property to determine its condition and the efficiency of management. This is exclusive of the property management fee, which is a property expense.

Practically all investments today contain elements of risk - some greater than others. The government securities mentioned above probably have the minimum risk rate of any investment today, while speculative enterprises have the greatest. The supply of real estate is relatively fixed, is immobile and is slow to react to changing demands, causing at times large surpluses which cannot be used or taken to a favorable market. These adverse economic conditions combined with permanent losses from unforeseen shifts in social and business activities may cause excessively unstable conditions. Taxation, controls, regulations, restrictions and competition which have now become a prerogative of government will have an effect on capitalization rates because of the uncertainty of future government actions as well as the direct action increasing the risk. However, in certain cases such as insured loans under FHA and under the GI bill the government has directly reduced the risk factor.

A fifth element, considered by some appraisers, affecting the capitalization rate is the extent of enterprise features. This feature is greatest in parking lots, where little investment is required other than the investment in land. It is our opinion, however, that income should be carefully processed to eliminate the features of enterprise before capitalization, thereby eliminating the necessity of consideration in the determination of the capitalization rate.

Capitalization rates may be determined by any of three methods or a combination of them. These three methods are: by comparison, by summation or build-up, and by the investment rate method.

George L. Schmutz, Member of the American Institute of Real Estate Appraisers, is credited with the primary development of the comparative method. Briefly, this approach involves the discovery of sales of comparable properties whose sales prices and net incomes are known and from which the capitalization rate is computed. Then from a consideration of these rates found in the market, by comparison, a conclusion is formed as to the rate applicable to the property under consideration.

The summation or build-up method is probably the oldest and most popular method used today. This method evaluates the four basic factors or rates, namely: pure interest, non-liquidity, management and risk, and assumes the total to be the composite capitalization rate.

The "investment-rate" method was developed by Thurston Howard Ross, M.A.I., and is called the "band of investment theory." In this method the composite rate is determined by comparison of the interest rates prevailing for first and second mortgage money and the rate demanded by equity purchasers of com-

parable properties.

There are two schools of thought regarding capitalization rates for real estate valuation purposes: one favors the single rate and the other, the fractional rate. The single rate is a composite rate or an average of the rate used on the land and the rate used on the improvements. The "fractional rate" or the "split rate" theory directly applies the rate justified to the land to the income imputable to land and the rate justified to the improvements to the income imputable to them. The land rate, considered separately from the building, is always less than the building rate. This is primarily due to the fact that the building is subject to greater hazards during its shorter economic life. The land rate is generally known for established sections and uses, the established 100% locations maintaining the lowest land rate and speculative land with an uncertain future the higher rate. The rate is evidenced by long-term ground leases. The building or improvements rate is generally found residually in the consideration of the over-all rate in relation to the land rate. Consequently, it is directly dependent on the "land-to-building-cost" ratio - the greater the land value in relation to total value the greater the capitalization rate will be for the building or improvements.

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